

**FINAL REPORT
OF THE
PENSION MANAGEMENT
OVERSIGHT COMMISSION**



**Indiana Legislative Services Agency
200 W. Washington St., Suite 301
Indianapolis, Indiana 46204-2789**

November 2010

INDIANA LEGISLATIVE COUNCIL

2010

Senator David Long

Vice-Chairperson

Fort Wayne

Speaker B. Patrick Bauer

Chairperson

South Bend

Senator Vi Simpson

Bloomington

Representative Brian Bosma

Indianapolis

Senator Brandt Hershman

Monticello

Representative Earl Harris

East Chicago

Senator Connie Lawson

Danville

Representative Dale Grubb

Covington

Senator Brent Steele

Bedford

Representative Scott Pelath

Michigan City

Senator James Merritt

Indianapolis

Representative Russell Stilwell

Boonville

Senator Connie Sipes

New Albany

Representative William Friend

Macy

Senator Timothy Lanane

Anderson

Representative Kathy

Richardson

Noblesville

John M. Ross
Executive Director
Legislative Services Agency

Pension Management Oversight Commission

Membership Roster

Representatives

David Niezgodski, Chair
South Bend

Woody Burton
Whiteland

Suzanne Crouch
Evansville

Edward Delaney
Indianapolis

Senators

Philip Boots
Crawfordsville

Lindel Hume
Princeton

Karen Tallian
Portage

Greg Walker
Columbus

Lay Members

Matthew Buczolich
South Bend

Randy Novak
LaPorte

Steve Meno
New Palestine

Kip White
Covington

Legislative Services Agency Staff

James Sperlik, Fiscal Analyst
Peggy Piety, Staff Attorney
Allen Morford, Staff Attorney

November 2010

A copy of this report is available on the Internet. Reports, minutes, and notices are organized by committee. This report and other documents for this Commission can be accessed from the General Assembly Homepage at <http://www.in.gov/legislative/>.

FINAL REPORT

Pension Management Oversight Commission

I. STATUTORY AND LEGISLATIVE COUNCIL DIRECTIVES

The Indiana General Assembly enacted legislation (IC 2-5-12) directing the Pension Management Oversight Commission to do the following:

- (1) Study the investment and management practices of the boards of the public investment funds.
- (2) Determine what constitutes adequate wage replacement levels at retirement (including benefits from public retirement funds and Social Security) for public employees.
- (3) Study the impact of federal law and proposals concerning pensions, annuities, and retirement benefits.
- (4) Study the retirement funds established in IC 36-8.
- (5) Study the methods and levels of funding for public retirement funds.
- (6) Study other topics as assigned by the Legislative Council.
- (7) Study other topics as directed by the Commission chair.

The Pension Management Oversight Commission consists of 12 members: 4 representatives, 4 senators, and 4 lay members who must be experts in the areas of finance, investments, or pension fund management. The chair of the Legislative Council appoints the chair of the Commission.

The Legislative Council assigned the following additional responsibility to the Commission in 2010:

- (1) Study whether the Public Employees' Retirement Fund (PERF) and the Teachers' Retirement Fund (TRF) should include a clear summary of statutory requirements in any handbooks prepared for fund members.

II. INTRODUCTION AND REASONS FOR STUDY

Since its inception in 1985, the Commission has provided a bipartisan forum for the study of proposed changes in the laws governing Indiana's public pension funds. This year the Commission reviewed issues raised by PERF and TRF and various pension stakeholders.

The Commission determined that it would review the following issues:

A. PERF/TRF Issues

PERF/TRF brought the following issues for review by the Commission:

- (1) Technical correction to regular retirement status (PD 3153).
- (2) Purchase of prior PERF service for the Judges' Retirement System (PD 3154).
- (3) Noncode technical correction to clarify IC 33-38-7-16 as to changes made to the IRS Code.
- (4) Codification of a noncode provision concerning vesting period in the Prosecuting Attorneys' Retirement Fund (PD 3298).
- (5) TRF employer accounts in the 1996 Account (PD 3156).
- (6) For several PERF funds - employer submission of contributions, records, and reports electronically and due dates for employer submissions (PD 3157), and determination of interest rate for employer contributions (PD 3159).
- (7) Withdrawal of a member's annuity savings account before normal retirement (PD 3231).
- (8) Time period to issue final orders concerning disability determinations for the 1977 Police Officers' and Firefighters' Pension and Disability Fund.

B. Public Safety Issues

Tom Hanify of the Indiana Professional Firefighters Union brought the following issues before the Commission:

- (1) Discussion and clarification on partial lump sum distributions (PD 3376).
- (2) Addition of a public safety member to the PERF Board of Trustees (PD 3050).
- (3) Further discussion on pre-1990 line-of-duty disability determinations (PD 3412).

C. Employee Misclassification

SEA 23 (2010) required a report be made to the Commission from the Indiana Department of Labor concerning guidelines and procedures for investigating questions and complaints concerning employee misclassification.

D. HEA 1205 (2010) PERF/TRF Merger

Representative Niezgodski requested a report on the PERF/TRF merger.

E. Department of Labor Appropriation Reversions to the General Fund

Representative Niezgodski requested a report on the reversions.

F. PERF/TRF Alternative Investments

Representative Niezgodski requested a report on alternative investments.

G. Judges' Retirement System

The Commission heard from Judge Barbara Harcourt concerning the Judges' Retirement System.

III. SUMMARY OF WORK PROGRAM

During the interim following the conclusion of the 2010 session of the General Assembly, the Commission met on the following dates:

August 17, 2010
September 29, 2010
October 14, 2010

All three meetings were held in the State House in Indianapolis.

IV. SUMMARY OF TESTIMONY

A. Reports to the Commission

(1) PERF/TRF Annual Report

Mr. Steve Russo, Common Director of PERF/TRF, presented PERF/TRF's 2010 report to the Commission.

Overview

Mr. Russo said that PERF oversees six funds, with more than 260,000 members. Member and employer contributions paid in FY 2010 totaled \$689 M. Benefits to retirees and beneficiaries amounted to \$664 M in FY 2010. PERF net assets totaled \$14.0 B as of June 30, 2010.

TRF has two accounts, with the benefits the same for both. TRF has approximately

164,000 members. The net assets of TRF as of June 30, 2010, totaled \$8.1 B. PERF/TRF is the 58th largest pension fund in the United States.

Benefit Structure

PERF/TRF retirement benefits come in two parts. The defined benefit, or pension, is a lifetime monthly benefit ($1.1\% \times \text{high 5 salary years} \times \text{years of service}$) with a ten-year vesting requirement. Funds cannot be withdrawn prior to retirement. A member is eligible for full retirement benefits if:

- (1) the member is at least 65 years of age and has at least 10 years of creditable service;
- (2) the member is at least 60 years of age and has at least 15 years of creditable service; or
- (3) the member is at least 55 years of age and the member's age in years plus years of creditable service equal at least 85 (the Rule of 85).

The second part of the benefit is the defined contribution, or the annuity savings account (ASA). A 3% contribution is paid by the member or the employer. The funds are invested at the direction of the member. A member is fully vested on day one. Funds can be withdrawn upon termination prior to retirement. PERF/TRF are considered "hybrid" plans.

Financial Position

Mr. Russo reviewed the financial position of PERF/TRF. The market value of PERF/TRF assets as of October 31, 2007, amounted to \$27.0 B. As of June 30, 2010, the net assets totaled \$22.1 B. The following table shows the changes.

Market Value of Assets			
	Oct 31, 2007	June 30, 2009	June 30, 2010
PERF	\$17.8 B	\$12.4 B	\$14.0 B
TRF	\$9.2 B	\$7.2 B	\$8.1 B
Total	\$27.0 B	\$19.6 B	\$22.1 B

To return to the October 31, 2007, level, PERF/TRF must experience an increase of approximately 18%.

Investment Performance

Mr. Russo discussed investment performance. PERF/TRF investment returns exceeded established benchmarks for all asset classes, with all asset classes positive. The table below shows the results.

Investment Performance			
	1 Year	3 Year	5 Year
PERF CRIF* Benchmark	13.63% 11.60%	-6.14%	1.47%
TRF DB** Benchmark	14.31% 11.23%	4.19%	2.93%
Public Plan Median	12.92%		
S&P 500	14.43%		
*Consolidated Retirement Investment Fund **Defined Benefit			

Operations Update

PERF/TRF received the Public Standards Award for Funding and Administration from the Public Pensions Coordinating Council (PPCC). PERF/TRF are in year three of a five-year reorganization. Changes include implementation of daily valuations for the ASA. Further changes contemplated include modernization of employer wage, contribution, and demographic data reporting.

(2) PERF/TRF Merger

HEA 1205 (2010) required the PERF Board of Trustees and the TRF Board of Trustees to jointly appoint a common director and to cooperate to the extent practical and feasible in investing funds. Both a common director and a common executive staff were implemented in May and June of this year.

Investment cooperation has led to savings. Before the merger, investment teams achieved \$9.3 M in one-time savings and \$6.7 M in annual ongoing savings. The first two months of the merger produced an additional \$8.5 M in annual ongoing savings.

Lack of a single entity will prevent some savings. Savings over time will show up as decreased employer contributions. PERF/TRF was not able to provide a specific dollar amount on potential savings from consolidation, but PERF/TRF estimates for the savings range between \$1 M and \$6 M, annually.

(3) Terror States Divestment

HEA 1547 (2009) prohibits PERF/TRF from acquiring or owning securities of certain companies that have active business operations in a state that sponsors terror (scrutinized company). PERF/TRF are 100% divested from Sudan.

(4) Administrative Costs Involved in Divestment

Administrative costs for divestment from states that sponsor terror totaled \$239,000 for PERF and \$86,000 for TRF. Costs for divestiture from Sudan are shown below.

ITEM	PERF	TRF
Contractors	\$46,000	\$27,000
Staff time	\$26,000	\$19,500
Commissions	\$104,000	\$6,000

(5) Senate Resolution (SR) 74

SR 74 was the only topic assigned to the Commission and dealt with whether the PERF Board and the TRF Board should include a clear summary of statutory requirements in any handbooks prepared for fund members. SR 74 was brought by Senator Jean Breaux on behalf of a teacher who reallocated her investment funds in December, not realizing that her account was valued as of September, the end of the previous quarter. Mr. Russo said that daily valuations, now in effect, would preclude any further problems with delayed valuations.

(6) Status report on the implementation of the Retirement Medical Benefit Account established by SEA 501 (2007) (P.L. 44-2007).

Adam Horst, Director of the State Budget Agency, presented the annual update on the implementation of the retirement medical benefits account (Account). The Account was established in 2007 by SEA 501 for all state employees, including members of the General Assembly.

Mr. Horst reviewed the fiscal impact of the Account for FY 2010. The general fund appropriation was \$27.4 M from the cigarette tax. The actual cost for FY 2010 is shown below:

- \$35.9 M for annual contributions
- \$21.2 M for bonus contributions
- less \$5 M in reversions due to individuals leaving state employment before full retirement

The state also incurs an actuarial unfunded liability that must be reported under GASB 45. The liability occurs because the General Assembly in 2008 allowed retirees to use the Account to purchase coverage in the state's self-insured health plans. Claims expenses for retirees are greater than the premiums they are charged, creating an implicit subsidy that is paid by the state and active employees through higher premiums. The implicit subsidy currently is estimated at a \$67.4 M unfunded liability, which would require an additional \$7.7 M to actuarially fund.

(7) Section 401(h) Update

Allison Murphy, Legislative Director of PERF, presented an update concerning the Section 401(h) account administered by PERF. PERF is currently waiting on Internal Revenue Service approval.

(8) PERF/TRF composition of the Boards of Trustees

Steven Barley, Chief Operating Officer of PERF/TRF, presented the composition of the respective boards. The TRF Board has six members, five appointed by the Governor. At least two of the five must be members of the TRF. The sixth member is the director of the State Budget Agency, or the director's designee. The TRF Board, including the five governor appointees are:

Ken Cochran, (President)
Gregory Hahn (Vice-President)
Cari Whicker (Secretary & TRF member)
Allen Clark (TRF member)
Bret Swanson
Director of the State Budget Agency or designee Chris Ruhl, OMB Director

The PERF Board has six members, five appointed by the Governor. One member must be a vested member of PERF. One member must be a member or retired member of the fund or a member of a collective bargaining unit, or an officer of a labor union that represents state or university employees and is an Indiana resident. Not more than three may be members of the same political party. The sixth member is the director of the State Budget Agency or the director's designee. The PERF Board, including the five governor appointees are:

Ken Cochran, (President) (R)
Gregory Hahn (Vice-President) (R)
Cari Whicker (I)
Allen Clark (PERF member) (D)
Bret Swanson (R)
Director of the State Budget Agency or designee Chris Ruhl, OMB Director.

(9) Employee Misclassification

SEA 23 (2010) required a report be made to the PMOC from the Indiana Department of Labor (IDOL) concerning guidelines and procedures for investigating questions and complaints about employee misclassification.

Ms. Lori Torres, Commissioner of the Department of Labor, presented the report to the Commission. Among the recommendations was that an interagency initiative be undertaken with representatives of the Department of Workforce Development (DWD), the state Department of Revenue (DOR), the Indiana Attorney General's Office, the Worker's Compensation Board (WCB), the Indiana Secretary of State, and IDOL.

Recommendations included:

- (1) An interagency memorandum of understanding which would document the initiative and the commitment of the agencies.
- (2) Agencies should be responsible for providing investigators and administrative staff sufficient to participate in the overall enforcement activities.
- (3) Changes should be adopted to allow the WCB to impose monetary fines for failure to have coverage before a worker is injured.
- (4) Education, outreach, and compliance assistance should be enhanced.

A. Comments on IDOL Employee Misclassification Report to the Commission

Mr. Peter Rimsans, Executive Director, Indiana State Building and Construction and Trades Council, told the Commission that the rules proposed by the IDOL for implementation of SEA 23 (2010) were lacking in several categories, among them, not following rule-making requirements, lack of remedies for misclassification, and the lack of a definite standard of proof.

B. Department of Labor - Appropriation Reversions to the State General Fund

Representative Niezgodski requested a report from the IDOL on their reversions to the state General Fund. Commissioner Torres provided the report. The report showed IDOL General Fund expenditures, federal grants, and the full-time equivalent (FTEs) staffing levels; however, specific reversion amounts were not listed. Senator Tallian provided the Commission with a reversion report which listed total reversions.

(10) Economic Costs of Employee Misclassification in the State of Indiana

Dr. Michael Kelsay, Department of Economics, University of Missouri-Kansas City, presented his report. Indiana is losing between \$250 M and \$400 M in income and payroll taxes, annually. Misclassification occurs when employers treat their workers as independent contractors, rather than waged or salaried employees.

Employers who cheat the system have an unfair pricing advantage by decreasing payroll costs, estimated to range between 10% and 20%. The Unemployment Insurance Trust Fund also is reduced, along with the Worker's Compensation Fund. Recommendations in the report included:

- (A) Urging DWD to continue high-percentage audits;
- (B) Establishing meaningful penalties;
- (C) Reviewing state agency procedures and state law to streamline enforcement;
- (D) Coordinating efforts, and
- (E) Expanding outreach and education to employers and employees.

(11) Use of Proceeds from Civil Forfeitures

The issue was brought about by a question from a Commission member about how proceeds from civil forfeitures might be used to fund pensions. Staff presented a report on the uses of civil forfeitures. Indiana law specifies that any value from civil forfeitures prosecuted in circuit, superior, or county courts in excess of the value of the proceeds or the money over the law enforcement costs are to be deposited in the Common School Fund.

For civil forfeitures transferred to federal authorities, the proceeds must be used solely for the benefit of any agency directly participating in the seizure or forfeiture for purposes consistent with federal laws and regulations.

(12) Public Safety

(A) Partial Lump Sum Distribution

Mr. Hanify of the Professional Firefighters' Union of Indiana and Mr. Leo Blackwell of the Indiana Fraternal Order of Police suggested a further review of the lump sum distribution proposal. Questions of its fiscal neutrality were raised, depending upon the structure of the proposal.

(B) Adding a Public Safety Officer to the PERF Board of Trustees

Mr. Hanify and Mr. Blackwell, along with Representative Dennis Tyler, proposed adding a public safety officer to the PERF Board of Trustees.

(C) Further Review of the Pre-1990 Line-of-Duty Disability Determinations

Mr. Hanify and Mr. Blackwell proposed further review of the topic of pre-1990 line-of-duty disability determinations.

(13) Indiana State Employees Association

Dave Larson, representing the Indiana State Employees Association, commented that any savings from the consolidation of the PERF/TRF Boards of Trustees should be used to help state employees with health care.

(14) PERF/TRF Report on Alternative Investments

A. Definition

Mr. David Cooper, Chief Investment Officer for PERF/TRF, told the Commission that alternative investments are investable assets other than publicly traded stocks and bonds employed to diversify and reduce the risks of long-term portfolios. Mr. Cooper said that PERF/TRF are long-term investors.

B. Fees

Fees for PERF amounted to \$74.4 M in FY 2010, while fees for TRF totaled about \$40 M in FY 2010.

(15) Judges' Retirement Issue

The Commission heard testimony from Judge Barbara Harcourt regarding HB 1350 (2006). HB 1350 authorized a participant with at least eight years in the Judges' Retirement System who is also vested in the Public Employees' Retirement Fund to elect to use not more than ten years of PERF service to qualify for a retirement benefit from the Judges' Retirement System and waive the right to a retirement benefit from PERF. It requires the PERF Board of Trustees to transfer to the Judges' Retirement System the amount credited to the participant's annuity savings account and the present value of the retirement benefit payable at 65 years of age that is attributable to the participant who makes the election. The bill provided that the PERF service credit may not be used to compute the participant's retirement benefit from the Judges' Retirement System.

V. COMMITTEE FINDINGS AND RECOMMENDATIONS

The Commission made the following recommendations:

A. Preliminary Drafts of Proposed Legislation

PD 3050 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3050 adds a police officer or firefighter to the Board of Trustees of the Public Employees' Retirement Fund.

PD 3153 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3153 makes technical corrections to the 1977 Police and Fire Funds.

PD 3298 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3298 codifies P.L. 33-2006 concerning the Prosecuting Attorneys' Retirement Fund.

PD 3156 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3156 removes a provision requiring the TRF to maintain separate accounts for each employer within the retirement allowance account.

PD 3157 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3157 requires the PERF-managed funds to submit contributions, reports, and records electronically and authorizes the PERF Board of Trustees to establish due dates for the contributions, reports, and records.

PD 3231 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3231 permits a member of PERF or TRF who is eligible for an early retirement to withdraw the member's annuity savings account without applying for a retirement benefit.

PD 3232 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3232 permits an administrative law judge, for cause shown, to order the waiver or extension of the 180-day limit in which the Board of Trustees of PERF is required to issue a final order after the date the PERF Board of Trustees receives a local board's initial disability determination or the PERF Director initiates a review of a default award for a member of the 1977 Police and Fire Funds.

PD 3154 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3154 provides that a judge or a magistrate who is a participant in the Judges' Retirement System and who purchases prior service credit in the Public Employees' Retirement Fund waives credit for prior service in PERF only for the amount of PERF service credit purchased.

PD 3159 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3159 requires that the Board of Trustees of the Public Employees' Retirement Fund specify by rule the interest rate credited to a participant's contributions for: (1) the State Excise Police, Gaming Agent, Gaming Control Officer, and Conservation Enforcement Officers' Retirement Fund; (2) Judges' Retirement System; (3) the Prosecuting Attorney's Retirement Fund; and (4) the 1977 Police Officers' and Firefighters' Pension and Disability Fund.

PD 3376 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3376 provides that an active member of the 1977 Police Officers' and Firefighters' Pension and Disability Fund (1977 Fund) who has entered the Deferred Retirement Option Plan (DROP) before July 1, 2011, may elect to receive a partial lump sum distribution. The bill provides that if a 1977 Fund member who has entered the DROP before July 1, 2011, elects a partial lump sum distribution: (1) the 1977 Fund member shall exit the DROP; and (2) the 1977 Fund member's retirement benefits are calculated as if the 1977 Fund member never entered the DROP. The bill provides that a 1977 Fund member who enters the DROP after June 30, 2011, may not elect to receive a partial lump sum distribution.

PD 3412 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3412 allows a certain member or survivor of a member of the 1977 Police Officers' and Firefighters' Pension and Disability Fund who applied for disability prior to 1990 and is receiving a disability benefit to apply to a local board for a recommendation as to whether the member's disability occurred in the line of duty. The bill provides that the local board shall make a recommendation of its findings to the 1977 Fund Advisory Committee. It provides that the 1977 Fund Advisory Committee shall make an initial determination of whether the member's disability occurred in the line of duty. It provides that if the 1977 Fund Advisory Committee fails to timely provide an initial determination, the default determination will be made by the Public Employees'

Retirement Fund's medical authority. The bill provides that the PERF Board makes a final determination of whether the member's disability occurred in the line of duty. It establishes procedures to appeal: (1) a recommendation by the local board; (2) an initial determination by the 1977 Fund Advisory Committee; or (3) an initial default determination made by the PERF medical authority. The bill provides that a certain member or survivor of a member may apply to the local board within two years of the PERF Board providing notice that it has received a favorable ruling from the Internal Revenue Service. The bill provides that the PERF Board shall provide notice to certain 1977 Fund members of the Internal Revenue Service's ruling within 30 days of its receipt.

PD 3253 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3253 provides a thirteenth check to participants of the State Excise Police, Gaming Agent, Gaming Control Officer, and Conservation Enforcement Officers' Retirement Fund Plan. It provides that the thirteenth check is to be paid not later than July 1, 2011, to a participant (or to a survivor or beneficiary of a Plan participant) who retired or was disabled on or before December 1, 2009, and who was entitled to receive a monthly benefit on July 1, 2010.

PD 3261 was unanimously recommended for introduction in the 2011 session of the General Assembly. PD 3261 provides a thirteenth check to participants of the State Police pre-1987 Benefit System (pre-1987 System). It provides that the thirteenth check is to be paid, not later than July 1, 2011, to each employee beneficiary of the pre-1987 System who: (1) retired or was disabled before July 2, 2008, and (2) was entitled to receive a monthly benefit before June 1, 2010.

NOTE:

The Commission voted unanimously to combine PD 3253 and PD 3261.

The Commission voted unanimously to adopt the following.

The Pension Management Oversight Commission as part of its final report for the 2010 interim unanimously adopted a recommendation that the Department of Revenue, the Department of Labor, the Department of Workforce Development, and the Worker's Compensation Board submit by November 1, 2010, a joint report in an electronic format under IC 5-14-6 to the Legislative Council concerning the following:

- (1) An estimate of the potential revenue recoverable annually by the state through the enforcement of existing statutory provisions concerning worker misclassification.
- (2) An estimate of the annual costs of enforcement to recover the revenue estimate provided in (1), above.
- (3) An estimate of the amount of additional potential expenditures for state benefits, such as unemployment insurance and worker's compensation

benefits, resulting from the reclassification of workers as employees as the result of the enforcement efforts described in (1), above.

(4) Recommendations concerning the funding of the estimated annual enforcement costs provided in (2), above, including a mechanism for paying for the additional costs of enforcement and compliance.

Final Report

The Commission voted unanimously to accept the draft copy of the Final Report with the understanding that action taken at the Commission's final meeting on October 14th would be included in the final report.

WITNESS LIST

Steve Barley
Leo Blackwell
Senator Jean Breaux
James Campbell
David Cooper
Tom Hanify
Barbara Harcourt
Adam Horst
Michael Kelsay, Ph.D.
David Larson
Allison Murphy
Margaret Piety
Peter Rimsans
Steve Russo
Lori Torres
Representative Dennis Tyler
Michael Whited